

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Machado Analyst: Jeani Brent Bill Number: AB 2798
Related Bills: See Legislative History Telephone: 845-3410 Amended Date: 08/10/98
Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Omnibus Tax Measure

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

☒ FURTHER AMENDMENTS NECESSARY.

☒ DEPARTMENT POSITION CHANGED TO Pending.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____ STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY OF BILL

This bill makes various changes to the income and franchise tax laws, including:

- Economic Development Areas:** Under the Government Code, this bill would modify the designation period and size of enterprise zones that meet specific criteria and would provide that Trade and Commerce Agency (TCA) may audit enterprise zone programs and determine a result of superior, pass, or fail and may dedesignate failing programs. Under the Revenue and Taxation Code, this bill would (A) modify the income apportionment rules for most economic development area tax incentives, (B) change the criteria in the targeted tax area hiring credit definition of "qualified employee," and (C) expand the definition of qualified property for the enterprise zone sales or use tax credit.
- Research Expenses Credit.** This bill would revise the state alternative incremental credit by modifying the formula to 80% of the federal alternative incremental credit formula. Also, this bill would technically correct a reference in the state research expenses credit to a federal code section.
- Employer Child Care Credits.** This bill would extend the sunset date of the Employer Child Care Program and the Employer Child Care Contribution credits from taxable or income years beginning before January 1, 1998, to years beginning before January 1, 2003.
- Manufacturer's Investment Credit.** This bill would extend the Manufacturers' Investment Credit (MIC) to manufacturers of custom or prepackaged computer software (involved in activities described in Standard Industrial Classification (SIC) codes 7371 to 7373).

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

9/17/98

5. **Self-Employed Health Insurance.** This bill would increase the deductible percentage of self-employed health insurance costs from 25% to 40%.
6. **Minimum Franchise Tax.** For income years beginning on or after January 1, 1999, this bill would reduce the minimum franchise tax for qualified new corporations, as defined, from \$600 to \$300 for the first income year and to \$500 for the second income year. In addition, this bill provides a legislative declaration regarding the important role that small businesses fulfill in California and stating that the minimum franchise tax and second year prepayments are costly and unjustified burdens.

This bill also would make changes to the state's sales tax and estate tax laws. This analysis will discuss only those provisions that would impact the department's programs. Except the discussions immediately below, which apply to all issues, each issue will be discussed separately in this analysis.

SUMMARY OF AMENDMENT

The August 10, 1998, amendments entirely replaced the bill's provisions relating to vehicle license fees with the provisions discussed in this analysis.

EFFECTIVE DATE

This bill's provisions would become effective immediately as an urgency statute and generally would apply to taxable or income years beginning on or after January 1, 1998. The self-employed health insurance and minimum franchise tax provisions would apply to taxable or income years beginning on or after January 1, 1999. However, this bill specifies that if Proposition 7 of the November 3, 1998, general election is approved by the voters, this bill will be deemed to have been inoperative from the effective date of the bill.

IMPLEMENTATION CONSIDERATION

In addition to any issue-specific implementation considerations, which are discussed separately in this analysis, the interaction between this bill and Proposition 7 raise the following implementation considerations:

Generally, the department completes the development of forms and instructions by each October, at which time the designs are sent to the state printing office. This timing is integral in meeting the department's goals of providing forms and instructions to taxpayers no later than the following January. If this bill becomes law in August or September, the department would need to develop forms and instructions that include this bill's provisions. However, because the department's deadline for completion of forms development occurs before the date the general election is held, the department also would need to develop forms and instructions that do not include this bill's provisions in preparation for the potential passage of Proposition 7 on November 3, 1998. Also, to avoid printing two full sets of forms and instructions, the department would need to delay sending the forms and instructions designs to the state printing office until after the November election.

Further, the department generally begins updating the electronic information systems immediately after bills are enacted into law to provide enough time to

complete and thoroughly test the new program changes before any tax returns are filed. Because this bill's provisions may be made inoperative in November by the passage of Proposition 7, the department would need to delay updating the electronic information systems until after the general election. This delay would diminish the department's ability to properly test the new programs before tax returns are filed.

DEPARTMENTAL COSTS

In addition to any issue-specific costs, which are discussed separately in this analysis, the interaction between this bill and Proposition 7 raise the following departmental costs:

This bill would result in minimal costs to develop alternate forms and instructions. In addition, this bill would result in minimal costs as a result of delay in providing the forms and instructions to the state printing office. Further, this bill potentially would result in minimal costs associated with information system program errors that may not be corrected prior to the time taxpayers file their returns.

REVENUE ESTIMATE

Based on data and assumptions discussed below, revenue losses from this bill are estimated to be as follows:

Estimated Revenue Impact of AB 2798 Amended August 10, 1998 (In \$Millions)				
		1998/99	1999/00	2000/01
1.	Economic Development Areas	(\$3)	(\$3)	(\$3)
2.	Research Expenses Credit	(\$15)	(\$18)	(\$20)
3.	Employer Child Care Credits	(\$10)	(\$11)	(\$13)
4.	Manufacturer's Investment Credit	(\$6)	(\$7)	(\$8)
5.	Self-Employed Health Insurance	*	(\$12)	(\$14)
6.	Minimum Franchise Tax	(\$4)	(\$11)	(\$11)

Note: * = No revenue effect

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

BOARD POSITION

Pending.

ISSUE #1: Economic Development Areas

EFFECTIVE DATE

Except as discussed on page two of this analysis, the changes made to the Revenue and Taxation Code would apply to taxable or income years beginning on or after January 1, 1998. The Government Code provisions would be effective upon enactment of the bill, except as provided on page two.

LEGISLATIVE HISTORY

AB 1937, AB 2205, AB 2809, SB 1814, SB 2234 (1998); AB 3, AB 69, AB 82, AB 638, AB 809, AB 1217 (Stats. 1997, Ch. 602), SB 200 (Stats. 1997, Ch. 609), SB 635, SB 965 (Stats. 1997, Ch. 603); AB 2456 (1996), AB 296 (Stats. 1996, Ch. 953), SB 715 (Stats. 1996, Ch. 952), SB 2023 (Stats. 1996, Ch. 955); SB 712 (Stats. 1995, Ch. 494); AB 2206 (Stats. 1994, Ch. 853), SB 1438 (Stats. 1994, Ch. 754), SB 1770 (Stats. 1994, Ch. 755).

PROGRAM HISTORY/BACKGROUND

California has five types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Los Angeles Revitalization Zone (LARZ),
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA).

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LARZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	X	
Hiring Credit	X	X	X	X	X
Construction Hiring Credit		X			
Employee Wage Credit	X				
Business Expense Deduction	X	X	X	X	
Net Interest Deduction	X	X			
Net Operating Loss	X	X	X	X	

* NOTE: the LARZ expires December 1, 1998.

SPECIFIC FINDINGS

Under the Government Code, existing state law provides for the designation of enterprise zones, the Los Angeles Revitalization Zone (LARZ), Local Agency Military Base Recovery Areas (LAMBRA), a Targeted Tax Area (TTA), and Manufacturing Enhancement Areas (MEA). Using specified criteria, the TCA designates these economic development areas from the applications (maps in the case of the LARZ) received from the governing bodies. Enterprise zones are designated for 15 years and TCA has designated the 39 enterprise zones authorized under existing law. The LARZ was designated in 1992 and is binding for five years. Five LAMBRA designations are authorized, one from each of the five regions (as specified) of the state. Currently, TCA has designated two of the five LAMBRA's authorized under existing law and the other three areas have received conditional designation. Each LAMBRA designation is binding for eight years. The TTA and MEAs were authorized in 1997 and are binding for 15 years beginning January 1, 1998.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit, hiring

credit, business expense deduction, and special net operating loss treatment. Two additional incentives include a net interest deduction for businesses that make loans to businesses within the economic development areas and a tax credit for employees working in an enterprise zone.

Under the Government Code, this bill would (1) extend the designation period of each enterprise zone that was designated before 1990 from 15 to 20 years if certain criteria are met; (2) allow for geographic expansion of 20% (rather than 15%) of any enterprise zone that is no greater than 13 square miles; (3) provide that TCA may audit enterprise zone programs and determine a result of superior, pass, or fail, and may dedesignate failing programs, and (4) provide that TCA could designate additional enterprise zones upon the expiration of existing ones to maintain a total of 39. This bill specifies that any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable or income year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the enterprise zone, provided the business otherwise is still eligible for those incentives. Further, this bill states that a dedesignated enterprise zone is no longer a zone for designation purposes.

Under the Revenue and Taxation Code, this bill would:

1. Modify the income apportionment rules for most economic development area tax incentives to a two-factor formula using a denominator of California sourced income instead of worldwide income. This bill would not change the apportionment formula for the LAMBRA sales or use tax credit or hiring credit, thereby unintentionally providing two different apportionment formulas for LAMBRA taxpayers.
2. Expand the definition of qualified property for the enterprise zone sales or use tax credit to include data processing and communication equipment and motion picture manufacturing equipment.
3. Technically change the criteria in the targeted tax area hiring credit definition of "qualified employee" to include an individual who is a member of a targeted group under the federal work opportunity credit instead of the expired federal Targeted Jobs Tax Credit Program.
4. Make nonsubstantive technical changes.

Implementation Considerations

Except as discussed on pages two and three of this analysis, implementing this provision generally would occur during the department's normal annual system update. However, the provision leaves unclear whether taxpayers engaged in business operations in an area that has been dedesignated, and thus is no longer an enterprise zone, could continue to earn new tax incentives because the Revenue and Taxation Code provisions specifically provide that, to be eligible for the incentives, the taxpayer must be operating in an enterprise zone.

FISCAL IMPACT

Departmental Costs

Except as discussed on page three of this analysis, this provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this provision is estimated to be:

Effective on or after January 1, 1998 (\$ In Millions)			
1998-9	1999-0	2000-1	2001-2
(\$3)	(\$3)	(\$3)	(\$3)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Extend enterprise zones to 20 years (rather than 15). The department historically has interpreted the Government Code provision limiting the number of enterprise zone designations to 39 as providing that once the designations expire, no new designations may be made without further legislation. The department's revenue estimates of bills that would extend the length or expand the number of enterprise zone designations have reflected the department's interpretation of that Government Code provision. However, this Government Code provision has been interpreted by TCA and others as providing that a total of 39 enterprise zones may continue to exist beyond the expiration of the statutorily provided designation periods and this bill statutorily clarifies that intent. Thus, once one enterprise designation expires, TCA may designate another enterprise zone, to maintain a total of 39. This revenue estimate reflects this interpretation.

Expand enterprise zones up to 20% in size. The impact for the expansion of the area of an enterprise zone by 20% rather than 15% is estimated to be \$500,000 annually.

Expand enterprise zone definition of qualified property. Including data processing and communication equipment and motion picture manufacturing equipment for the sales or use tax credit is estimated to be on the order of \$500,000 annually.

Modify income apportionment formula. The impact of a two-factor apportionment formula for economic development area tax incentives depends on the ratio of the taxpayer's sales factor to the sum of the taxpayer's property and payroll factors. If the sales factor is less than 50% of the sum of the property and payroll factors, the taxpayer would have greater income attributable to the area under the proposed changes, and thus be able to use a greater amount of economic development area credits or net operating loss deduction. Conversely, if the sales factor were greater than 50% of the sum of the property and payroll factors, the taxpayer would be disadvantaged. Based on the results of a prior special sample for corporate

taxpayers in the LARZ, net revenue losses are expected due to lower sales factors relative to combined property and payroll factors. The order of magnitude loss for a two-factor apportionment formula for economic development area tax incentives is projected at \$1 million annually.

Additionally, changing from worldwide to California sourced income in the denominator of the apportionment formula for all economic development area tax incentives is projected to be annual revenue losses of \$1 million. The combined loss from these two apportionment formula changes is estimated to be \$2 million annually.

Dedesignate enterprise zones that do not meet criteria and designate new enterprise zones. Any revenue effect for this provision would not occur until an enterprise zone is revoked and replaced by a new enterprise zone. Because this bill would deem a dedesignated enterprise zone no longer to be an enterprise zone, TCA could designate a new enterprise to maintain a total of 39. Thus, taxpayers in the dedesignated zone would continue to receive tax incentives after the new enterprise zone has been designated. The revenue impact of dedesignation and of the continuation of tax benefits after dedesignation is unknown as it would depend on relative tax benefits, prior enterprise zones versus new enterprise zones.

ISSUE #2: Research Expenses Credit

EFFECTIVE DATE

Except as provided on page two of this analysis, this provision would apply to taxable and income years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 1042 (Stats. 1997, Ch. 613), SB 455 (Stats. 1997, Ch. 611), AB 1067, AB 1499 (1997); AB 3408 (1996), SB 38 (Stats. 1996, Ch. 954); AB 365, AB 397, AB 917, SB 681 (1995); AB 2407 (Stats. 1994, Ch. 949); AB 1824, AB 1893, AB 1911 (1993), SB 671 (Stats. 1993, Ch. 881); SB 1853, AB 2508 (1992); AB 274 (Stats. 1990, Ch. 452); AB 802 (Stats. 1989, Ch. 1352); AB 2130 (Stats. 1988, Ch. 11); AB 53 (Stats. 1987, Ch. 1138).

PROGRAM HISTORY/BACKGROUND

Senate Bill 455 (Stats. 1997, Ch. 611) generally conformed California law to federal law. However, for purposes of the research credit, SB 455 provided that for 1997 taxable or income years, the 1997 changes to the federal research credit do not apply for state purposes.

Assembly Bill 1042 (Stats. 1997, Ch. 613) conformed the California research credit to the 1997 changes to the federal research credit, but reduced the alternative incremental credit by an 11:20 ratio and specified that the changes apply beginning with the 1998 taxable or income years.

However, AB 1042, enacted after SB 455, chaptered out and thus eliminated the SB 455 provisions that would have made the 1997 federal changes not apply for state purposes for 1997. As a result, state law is fully conformed to the

federal alternative incremental credit amounts and any other 1997 federal changes for 1997 taxable or income years only. For 1998 taxable or income years and thereafter, the state alternative incremental credit amounts are a relative percentage of the federal alternative incremental credit amounts (using the ratio that exists in current law between the federal (20%) and state (11%) research tax credits).

SPECIFIC FINDINGS

Existing federal law provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year.

A 20% research tax credit also applies to the excess of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit."

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers, including any firm that had both gross receipts and qualified research expenses in the first taxable year beginning after 1983 (so-called "start-up firms"), are assigned a fixed-base percentage of 3%.

In computing the credit, a taxpayer's base amount may not be less than 50% of its current-year qualified research expenditures. To prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer. Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise allowable) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the

taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. Taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses"); and (4) 75% of amounts paid to a research consortium for qualified research if the research consortium is a tax-exempt organization and is organized and operated primarily to conduct scientific research, and the qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the existing research expenses deduction requirements but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Existing state law conforms with specific modifications to the federal research credit, as follows:

- For corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, the definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
- "Basic research" must be conducted in California to qualify for the California credit.
- Research that has a specific commercial objective may qualify as "basic research."

- The credit percentage is 11% for qualified research and 24% for corporations for "basic research." To duplicate the federal provision that allows the credit for "basic research" payments only to corporate taxpayers, the Bank and Corporation Tax Law (B&CTL) allows the credit based on "qualified research" expenses and "basic research" payments, while the Personal Income Tax Law (PITL) allows the credit only for "qualified research" expenses.
- The state alternative incremental credit amount is a relative percentage of the federal alternative incremental credit amount using the ratio that exists in current law between the federal (20%) and state (11%) research tax credits.
- California taxpayers may make the alternative incremental credit election at any one time, instead of having a window period for making the election that is comparable to the federal credit. Also, a taxpayer's federal election is not binding for state purposes.
- The state definition of "gross receipts" for purposes of the credit differs from that used in the federal credit.
- The termination dates provided under federal law do not apply to state law. The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

This bill would revise the state alternative incremental credit by modifying the formula to 80% of the federal alternative incremental credit formula.

This bill also would specify that "qualified research expense" would not include any amount paid or incurred for tangible personal property that is eligible for the sales tax exemption provided under Section 6378 of the Revenue and Taxation Code (relating to property used in teleproduction and postproduction services).

In addition, **this bill** would technically correct a reference in the state research expenses credit to a federal code section.

Implementation Considerations

Except as discussed on pages two and three of this analysis, implementing this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

Except as discussed on page three of this analysis, this provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this provision is estimated to be:

Effective on or after January 1, 1998 (\$ In Millions)			
1998-9	1999-0	2000-1	2001-2
(\$15)	(\$18)	(\$20)	(\$17)

Tax Revenue Discussion

The revenue impact above was estimated as follows. First, the revenue loss resulting from the alternative incremental credit under existing B&CTL was estimated for 1994 using the department's bank and corporation tax samples as well as other corporate financial data. Next, the revenue loss resulting from the alternative incremental credit under the proposed higher credit rates was estimated. The differences were the bank and corporation tax revenue impact of the proposed bill based on 1994 data. Future revenue losses were extrapolated using the Department of Finance projected annual growth rates of corporate profits. Finally, the revenue impact under the PITL was assumed to be equal to 1% of the bank and corporation tax impact and was added to the corporate impact.

ISSUE #3: Employer Child Care Credits

EFFECTIVE DATE

Except as provided on page two of this analysis, this provision would apply to taxable and income years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

SB 722 (Stats. 1988, Ch. 1239); AB 802 (Stats. 1989, Ch. 1352); SB 227 (Stats. 1991, Ch. 476); SB 1863 (Stats. 1992, Ch. 816); AB 2688 (1994); AB 3144 (Stats. 1994, Ch. 748); AB 642 (1997).

PROGRAM HISTORY/BACKGROUND

Two employer child care credits were created by SB 722 (Stats. 1988, Ch. 1239) each with a sunset date of January 1, 1992, that later was extended to January 1, 1998. The Employer Child Care Program credit was for 30% of the costs of starting a child-care program or facility. The Child Care Contribution credit varied in amount based on whether contributions were to a full- or part-time qualified care plan for dependents of employees.

Over time, these credits have been amended to change certain definitions, the eligible age of the dependent of the taxpayer's employee, the percentage of the costs paid or incurred that qualify for the credit, and the amounts of the credits.

SPECIFIC FINDINGS

Existing state law allows employers a tax credit, known as the Employer Child Care Program Credit, equal to 30% of the cost paid or incurred for (1) establishing a child care program or constructing a child care facility in California to be used by their employees' children and (2) contributing to child care information and referral services. Building owners also are allowed a credit equal to 30% of their costs to establish a child care program or facility to be used by their tenants' employees' children. The amount of the credit is limited to \$50,000, even if 30% of the taxpayer's expenses exceeds \$50,000, but to the extent that the allowed credit cannot be used, a credit carryover is

permitted. The carried-over amount may be added to any credit for that succeeding year, which is still limited to \$50,000.

Existing state law allows employers a tax credit, known as the Employer Child Care Contribution Credit, equal to 30% of the cost paid or incurred for contributions to a qualified care plan made on behalf of any dependent under the age of 12 of the taxpayer's California employee, but only to the extent contributions are made directly to child care programs or providers. The amount of the credit cannot exceed \$360 in any year for each qualified dependent.

These credits are available for taxable or income years beginning on or after January 1, 1995, and before January 1, 1998, and may be carried over until exhausted.

This bill would extend the sunset date of both the Employer Child Care Program Credit and the Employer Child Care Contribution Credit to taxable or income years beginning before January 1, 2003, and extend the repeal date to December 1, 2003.

Implementation Considerations

Except as discussed on pages two and three of this analysis, implementing this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

Except as discussed on page three of this analysis, this provision would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses for these provisions are estimated as follows:

Effective on or after January 1, 1998 (\$ In Millions)				
	1998-9	1999-0	2000-1	2001-2
Bank & Corporation Tax	(\$9)	(\$10)	(\$12)	(\$14)
Personal Income Tax	(\$1)	(\$1)	(\$1)	(\$1)
Total	(\$10)	(\$11)	(\$13)	(\$15)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Revenue losses under the Personal Income Tax and the Bank and Corporation Tax Laws would depend on the number of taxpayers who contribute and the amount of contributions made to a qualified plan.

Actual tax data for 1995 taxable/income year indicate that there were \$7 million in applied credits (excluding prior year carryovers).

ISSUE #4: Manufacturer's Investment Credit

EFFECTIVE DATE

Except as discussed on page two of this analysis, this provision would apply to taxable and income years beginning on or after January 1, 1998. In addition, the bill would specify that, for taxpayers engaged in activities described in SIC codes 7371 to 7373, qualified costs for purposes of the MIC would not include any costs paid before January 1, 1998, that are associated with a binding contract in existence on or prior to January 1, 1998.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881); SB 676 (Stats. 1994, Ch. 748); AB 2661 (1995/96); SB 38 (Stats. 1996, Ch 954.); SB 1106 (Stats. 1997, Ch. 604); AB 1063 (1997/98); AB 2441 (1997/98).

SPECIFIC FINDINGS

Existing state law allows taxpayers to use various credits against tax. The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1. Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:
 - for manufacturing, processing, refining, fabricating or recycling of property;
 - for research and development;
 - for the maintenance, repair, measurement, or testing of otherwise qualified property; or
 - for pollution control which meets or exceeds state or local standards.
2. The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.
3. Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process, furniture, facilities used for warehousing purposes after completion of the

manufacturing process, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

The MIC will become inoperative on January 1, 2001, or on the January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Certain "new businesses" (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC.

This bill would include specified lines of business relating to computer programming and computer software in the definition of "qualified taxpayer" under the MIC. These activities are described in SIC Codes 7371 (Computer Programming Services), 7372 (Prepackaged Software) and 7373 (Computer Integrated Systems Design).

This bill also would include in the definition of "qualified property" under the MIC computers and computer peripheral equipment (as defined in IRC Section 168(i)(2)(B)) that is used in computer businesses described in SIC Codes 7371 to 7373 primarily for the development and manufacture of prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software. The value of any capitalized labor costs directly allocable to the construction or modification of such property also would be included in "qualified property." Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 to 7373 would not include any Section 1245(a)(3)(A) tangible personal property (e.g., shrink wrap machines, fork lifts, etc.) other than computers and computer peripheral equipment.

Implementation Considerations

Except as discussed on pages two and three of this analysis, implementing this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

Except as discussed on page three of this analysis, this provision would not significantly impact the department's costs.

Tax Revenue Estimate

This bill is estimated to impact personal income tax and bank and corporation tax revenues as shown in the following table.

Effective on or after January 1, 1998 (\$ In Millions)			
1998-99	1999-00	2000-01	2001-02
(\$6)	(\$7)	(\$8)	(\$9)

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this provision.

Tax Revenue Discussion

The revenue impact for this provision would be determined by the level of qualified costs and the amount of credits applied against available tax liabilities.

This estimate was developed in the following steps. The amount of qualified costs was estimated from national data (U.S. Department of Commerce) for SIC Code 737. That amount was adjusted, using sales receipt data, to provide a proxy for the portion of overall U.S. investment that may reasonably be assumed to be accounted for by activities in SIC Codes 7371, 7372 and 7373. The next step was to estimate the portion of national investment that would occur in California. California's share of the total was obtained by adjusting the U.S. capital expenditure figure by the ratio of California's employment over U.S. employment in SIC Codes 7371, 7372 and 7373. The qualified expenditures for 1993 were grown to approximate levels for 1998 adjusted by capitalized labor costs. This figure was adjusted downward to reflect the amendments which limit the credit to prepackaged software production. The final step was to estimate the amount of credit that would be used. This was accomplished using a microsimulation model of tax returns from prior years.

ISSUE #5: Self-Employed Health Insurance

EFFECTIVE DATE

Except as discussed on page two of this analysis, this provision would apply to taxable years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 1928, AB 2107, AB 2131 (1998); AB 230, AB 305, AB 1364 (1997).

SPECIFIC FINDINGS

Existing federal law (effective for 1998) provides a deduction of 45% of a self-employed individual's cost for health insurance for purposes of determining adjusted gross income (AGI). Federal law allows the deductible percentage to

increase incrementally to 100% beginning in the year 2007. The percentage is increased as follows:

- 45% in 1998 and 1999,
- 50% in 2000 and 2001,
- 60% in 2002,
- 80% in 2003 through 2005,
- 90% in 2006, and
- 100% in 2007 and thereafter.

Under existing state law, for taxable years beginning in 1997, the deductible percentage for self-employed health insurance costs for the purposes of determining AGI is 40%. For taxable years beginning on or after January 1, 1998, the California percentage reverts to the pre-1997 percentage of 25%. However, AB 2797 (Stats. 1998, Ch. 322) extended the 40% deduction for one year.

Under both federal and state law, the cost of health insurance incurred by a self-employed individual that is not deductible in determining adjusted gross income (AGI) may be taken as an itemized medical deduction. Itemized medical deductions are limited to the amount that exceeds 7.5% of the taxpayer's AGI.

Additionally, **under both federal and state law**, health insurance costs include premiums paid for health insurance of the taxpayer and the taxpayer's spouse and dependents. A deduction for self-employed insurance costs is not allowed if the taxpayer or taxpayer's spouse is eligible to participate in any employer subsidized health plan. The deduction is limited to the extent of the taxpayer's federal earned income from the business from which the health coverage was established.

This bill would allow as a state deduction 40% of the cost of health insurance incurred by a self-employed individual in the computation of adjusted gross income.

Implementation Considerations

Except as discussed on pages two and three of this analysis, implementing this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

Except as discussed on page three of this analysis, this provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue losses from this provision are estimated to be as shown in the following table.

Effective on or after January 1, 1999 (\$ In Millions)			
1998-9	1999-0	2000-01	2001-02
(*)	(\$12)	(\$14)	(\$16)

Note: * = No revenue effect

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this provision will be determined by the number of self-employed individuals who claim additional insurance deductions, and the average marginal tax rate applicable to the deduction amounts.

This estimate was developed in the following steps. First, the number of California resident taxpayers who currently claim the self-employed insurance deduction was calculated from returns filed for 1995 (425,000). Secondly, the current deduction amount of 25% was calculated to be \$839 on average for returns filed in 1995, making the average annual health insurance premium \$3,356 (\$839 x 4). Third, the estimated number of qualified taxpayers for 1995 was grown at 5% per year to yield 517,000 qualified taxpayers for 1999. Fourth, the insurance premium was grown at 7% per year to yield an average \$4,399 insurance premium for 1999. Fifth, the total deduction at 25% was calculated to be \$569 million for 1999 and the amount deducted for health insurance premiums on Schedule A was calculated to be \$407 million, generating a total deduction amount under current law of \$976 million. At an average marginal tax rate of 4.5% (computed by the PIT microsimulation model for self-employed individuals), the current law revenue loss for 1999 is \$44 million. Sixth, the total deduction was calculated at 40% at a 4.5% marginal tax rate for 1999, generating a \$41 million tax loss and the amount deducted for health insurance premiums on Schedule A was calculated to be \$15 million, generating a total \$56 million tax loss. These steps resulted in a 1999 estimate of an additional \$12 million tax loss. Losses were grown to reflect a combined annual growth of 5% (qualified taxpayers) and 7% (premiums) based on current historical averages.

ISSUE #6: Minimum Franchise Tax

EFFECTIVE DATE

Except as provided on page two of this analysis, this provision would become effective upon enactment and apply to certain minimum tax payments for income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 8, AB 27, SB 510, SB 842 (1997); SB 38 (Stats. 1996, Ch. 954), AB 546, AB 3010, AB 3298, AB 3394 (1996); AB 647, AB 744, AB 1098 (1995); AB 411, AB 977, AB 1721, AB 2886, AB 3807 (1993/94); AB 3506, SB 1453 (1992); AB 4275 (1989/90); SB 572 (Stats. 1987, Ch. 1139); AB 1 (Stats. 1971, Ch. 1); AB 1175 (Stats. 1957, Ch. 1127).

PROGRAM HISTORY/BACKGROUND

The minimum franchise tax was established to ensure that all corporations pay at least a minimum amount of franchise tax for the privilege of doing business in this state, regardless of the corporation's level of income (or loss). The minimum franchise tax has varied over the years. For income years ending before June 25, 1959, the minimum franchise tax was \$25. For income years ending after June 25, 1959, and beginning before January 1, 1972, the minimum franchise tax was \$100. For income years beginning after December 31, 1971, and before January 1, 1987, the minimum franchise tax was \$200. For income years beginning after December 31, 1986, and before January 1, 1989, the minimum franchise tax was \$300 (SB 572, Stats. 1987, Ch. 1139). This tax was increased to \$600 for income years beginning on or after January 1, 1989, and before January 1, 1990, and to \$800 for income years beginning on or after January 1, 1990. Beginning on January 1, 1997, "qualified new corporations," as defined, with estimated gross receipts of less than \$1 million are required to prepay a \$600 minimum franchise tax in lieu of the \$800 minimum franchise tax. The minimum franchise tax is \$25 for certain gold and quicksilver mining corporations. Credit unions, certain nonprofit cooperative associations, and domestic banks and corporations which have filed a certificate of dissolution are not subject to the minimum franchise tax.

Taxpayers are required to pay the minimum franchise tax for their first taxable year to the Secretary of State at the time they incorporate (California corporation) or initially qualify (non-California corporation) with that office to do business in this state. This initial payment constitutes the taxpayer's initial return. Because the taxpayer has no prior income year on which to measure the tax, the only tax due for the first taxable year is the prepaid minimum franchise tax.

Prepayment of the second year's minimum tax is due during the corporation's first year. At the end of the first year, even if it is not a full 12 months, taxpayers are required to compute their franchise tax for the privilege of conducting business during the second taxable year based on a measurement of the first year's net income. The taxpayer must file a corporate franchise tax return within two months and 15 days after the end of the first year and include payment of the taxes due for the second taxable year. The franchise tax for each subsequent taxable year is computed based on a measurement of the preceding year's net income. Under the rules for payment of estimated taxes, four equal payments are to be made during the current year for the privilege of exercising a corporate franchise in the subsequent year, but the first payment cannot be less than the \$800 minimum tax.

SPECIFIC FINDINGS

Under existing state law, every corporation that is organized or qualified to do business or is doing business in this state (whether organized in-state or out-of-state) is subject to the minimum franchise tax. Taxpayers must pay the minimum franchise tax only if it is more than their measured franchise tax. For income years beginning on or after January 1, 1998, only taxpayers whose net income is less than approximately \$9,040 pay the minimum franchise tax because their measured tax would be less than \$800 ($\$9,039 \times 8.84\% = \799).

Existing state law provides that real estate mortgage investment conduits (REMICs) are subject to and required to pay the minimum franchise tax. Regulated investment companies (RICs) and real estate investment trusts (REITs) organized as corporations also are subject to and required to pay the minimum franchise tax.

Existing state law requires nonprofit charitable organizations to file periodic reports with the Attorney General. For any year that a nonprofit charitable organization does not file with the Attorney General and the Attorney General notifies the department of this failure, the nonprofit charitable organization is assessed and required to pay the minimum franchise tax.

Under existing state law, the tax on limited partnerships (LPs), limited liability companies (LLCs), and limited liability partnerships (LLPs) is set at \$800 by reference to the amount provided in the minimum franchise tax statute.

Existing state law provides a reduced minimum franchise tax of \$600 for "qualified new corporations" with gross receipts, less returns and allowances, reportable to this state of less than \$1 million. The reduced tax applies only to the first taxable year commencing on the date the corporation is incorporated or registered with the Secretary of State.

Also, **existing state law** provides that the determination of whether a corporation meets the gross receipts criterion is based on the aggregate gross receipts of the members of a commonly controlled group. The law defines "gross receipts less returns and allowances reportable to this state" as including both business and non-business receipts.

The reduced minimum franchise tax does not apply to any corporation if 50% or more of its stock is owned by another corporation. In addition, it does not apply to certain entities such as limited partnerships, limited liability companies, and charitable corporations required to pay the minimum franchise tax as a result of failure to file with the Attorney General.

The corporation pays an additional tax of \$200 on the due date of its first return, without regard to extension, if the corporation's gross receipts exceed \$1 million or its tax liability exceeds \$800.

This bill would reduce the prepayment to the SOS for qualified new corporations from \$600 to \$300 for the qualified new corporations that incorporated on or after January 1, 1999.

This bill would reduce the minimum franchise tax from \$800 to \$500 for the second taxable year for corporations incorporated on or after January 1, 1999, with gross receipts, less returns and allowances reportable to this state, of less than \$1 million for the year.

This bill would require a qualified new corporation to pay an additional tax of \$500 for its first taxable year or \$300 for its second taxable year on the due date of its tax return, without regard to extension, if the corporation's first or second taxable year gross receipts exceed \$1 million.

This bill would modify the definition of "qualified new corporation" to include only businesses that begin operation at or after the time of its incorporation.

Further, "qualified new corporation" would not include any business that began operation as a single proprietorship, a partnership, or any other form of business prior to its incorporation. Thus, not all corporations that qualify for the \$600 minimum franchise tax under current law would continue to qualify for the lower taxes provided in this bill.

This bill would specify that the reduced minimum franchise tax does not apply to certain entities, including limited liability companies, limited liability partnerships, and subsidiaries.

This bill also would not apply to any corporation that reorganized solely for the purpose of reducing its minimum franchise tax.

Implementation Considerations

In addition to the implementation considerations discussed on pages two and three of this analysis, this provision raises the following implementation considerations:

This provision would not allow subsidiaries to be eligible for the reduced minimum franchise tax. The term "subsidiary" is not defined, which may lead to disputes between taxpayers and the department.

Qualifying corporations that pay the \$800 minimum franchise tax as their first estimate payment for the second income year beginning on or after January 1, 1999, but at the end of the year have gross receipts of \$1 million or less, would be eligible for a reduced minimum tax of \$500. Therefore, refunds would have to be sent to those taxpayers that overpaid their minimum franchise tax.

Also, this provision specifies that only new banks or corporations that begin operation at or after the time of incorporation would qualify as a "qualified new corporation." It may be difficult for the department to verify whether each "qualified new corporation" had operated in another business form prior to its incorporation.

Corporations with gross receipts of less than \$1 million would pay the reduced tax, while those with gross receipts which exceed \$1 million would pay the regular amount of minimum tax. The bill is silent on taxpayers with gross receipts of exactly \$1 million.

This provision uses the term "single proprietorship." It is unclear whether "single proprietorship" should be interpreted to mean a "sole proprietorship;" however, the department will interpret the statute to mean a sole proprietorship.

FISCAL IMPACT

Departmental Costs

This bill for qualified new corporations would provide two different amounts for the prepayment to the Secretary of State (\$300), and the taxpayer's minimum franchise tax (\$500) for its second income year, thus resulting in undetermined program changes and additional refunds to qualifying taxpayers. As a result, the departmental costs associated with the minimum franchise tax provisions of this bill cannot be determined at this time. However,

except as discussed on page three of this analysis, the impact is expected to be moderate.

Tax Revenue Estimate

Revenue losses from this provision are estimated as follows:

Effective on or after January 1, 1999 (\$ In Millions)			
1998-9	1999-0	2000-1	2001-2
(\$4)	(\$11)	(\$11)	(\$11)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Revenue losses under this provision would depend on the number of newly-formed businesses that incorporate and have gross receipts, less returns and allowances reportable to this state, of less than one million dollars in one or two of its initial two years of doing business (counting the Secretary of State fee as payment for its initial year).

The total number of new incorporations projected for 1999 is 57,000. The number qualifying as "newly-formed" and with less than \$1 million in gross receipts is projected at 17,540.